

CROSS-BORDER FINANCING ISSUES

February 28, 2013

Michael Bertrand

Goodmans^{LLP}

Barristers & Solicitors / goodmans.ca

INTRODUCTION

- Canadian companies are increasingly becoming involved in international financings
- Common Scenarios:
 1. Canadian corporation is a subsidiary of an international Corporation. Canadian corporation provides a guarantee of its international parent's borrowings
 2. Canadian corporation has subsidiaries formed in other countries. Canadian corporation looks to use the assets of these foreign subsidiaries to secure a loan made in Canada
 3. Canadian corporation looks to borrow funds from a foreign lender
 4. A foreign company borrows money from a foreign lender to acquire a Canadian corporation

CONSIDERATIONS

- All of the above scenarios raise a number of common issues to international financings:
 - How do lenders take security over the assets of the companies involved?
 - What law applies?
 - Does the security structure create any corporate law issues?
 - Does the security structure create any tax issues?
 - Are there currency exchange issues that need to be addressed?
 - Are there other issues to consider based on the jurisdictions involved?

SECURED LENDING – CONCEPT OF SECURITY

- Most commercial loan transactions involve some sort of security or collateral for the loan
- Common for lenders to take security over ALL personal property of a debtor
- Personal property security law is jurisdiction-specific, and can vary greatly from one jurisdiction to another:
 - In Canada, each province has its own personal property legislation (no uniformity)
 - Contrast to the U.S. that has adopted uniform legislation in all states
- When different jurisdictions are involved, there will often be a need to retain counsel in each jurisdiction
- Most common approach to taking security in North America: security-granting instrument and then “perfection” by registering a financing statement

1. HOW TO TAKE SECURITY – DIFFERENT LEGAL FRAMEWORKS

- Lenders want to make sure that security is enforceable against other creditors
- Legal framework to accomplish this can vary from jurisdiction to jurisdiction
- Area of law tends to be quite technical, with more formalities than other areas
- As a result there are typically more lawyer insurance claims for mistakes
- A loan involving security in many different jurisdictions can require many different legal documents and different sets of counsel

DIFFERENT LEGAL FRAMEWORKS

Ontario

- In Ontario, a security interest must have attachment and perfection to be enforceable against other creditors
 - Attachment requires the following:
 - Value is given in exchange for taking the security
 - The debtor has rights in the collateral
 - The debtor signs a security agreement (usually called a “General Security Agreement” if it covers all assets) that creates the security interest and contains a description of the collateral sufficient to enable it to be identified
 - Perfection is an additional step that varies depending on the type of collateral involved:
 - For most collateral, perfection occurs by registering a financing statement in the Ontario Ministry of Consumer and Business Services
 - For some types of collateral, it can also occur by having the lender take possession or “control”

DIFFERENT LEGAL FRAMEWORKS

Elsewhere In Canada

- All other Canadian provinces (except Québec) are similar to Ontario
- Because of this, an Ontario General Security Agreement generally is sufficient to create security in other non-Québec provinces
- However, each province still has its own registry (there is no central Canadian registry), which means that a financing statement cannot be registered in one province to perfect in another province, and multiple registrations are often required

DIFFERENT LEGAL FRAMEWORKS

Québec

- In Québec, the concepts and documents that are involved are different:
 - The concept of “perfection” is replaced with the concept of “publishing”
 - Security in tangible property is generally done by publishing a hypothec, which can be done by deed or pledge
 - Québec has additional formalities for signing a hypothec that other provinces do not have (it must be signed in Québec, and in some cases it must be in front of a Québec notary)
- As a result, you CANNOT use an Ontario security agreement to secure assets in Québec
- A separate Québec deed is usually needed, and Québec counsel must be retained
- Advance planning for signing is almost always required

DIFFERENT LEGAL FRAMEWORKS

United States

- The U.S. has a similar framework for attachment and perfection (i.e., security agreement / registration of a financing statement called a “UCC-1”)
- However, because laws are jurisdiction-specific, you still typically need a separate U.S. security agreement that refers to applicable U.S. laws for assets in the U.S.
- In contrast to Canada, all US states have a uniform form of financing statement (UCC-1)

DIFFERENT LEGAL FRAMEWORKS

Other International Jurisdictions

- English-speaking jurisdictions such as the United Kingdom have frameworks similar to Ontario
- However, each such jurisdiction will require its own form of security agreement and will have its own unique formalities:
 - In the UK, charges created by companies must be registered at the Company Charges Register within 21 days of creation
 - The UK also still has a concept of a “floating charge” to secure future assets (this concept no longer exists in most of Canada)
- Other jurisdictions have completely different frameworks
- KEY IS TO ENGAGE LOCAL COUNSEL IN EACH APPLICABLE JURISDICTION EARLY TO AVOID TRANSACTION DELAYS CAUSED BY FORMALITIES INVOLVED, ETC.

2. WHAT LAW APPLIES – CONFLICTS OF LAWS

- Because of the differing frameworks, most lenders will want (or if the law requires it, need) to have a local law security instrument should they ever have to enforce over assets in particular a jurisdiction
- Many countries (particularly those that do not have a central filing system, such as Canada) also have “Conflicts of Law” rules to help determine what law applies to a security interest and where to register a financing statement, conduct lien searches, etc.

CONFLICTS OF LAWS

Canada

- In Ontario, the following general rules apply to security interests (with exceptions):
 - For tangible personal property, the law of each province where the actual asset(s) are located governs
 - For intangible personal property, the law of where the debtor's chief executive office is located governs (at least for corporations)
- Other Canadian jurisdictions tend to mirror Ontario or have similar rules
- As a result in Canada, you need to search and file in each province where tangible assets are located and where the chief executive office is located

CONFLICTS OF LAWS

United States

- In the U.S., the rules are much simpler
- Security interests are governed by the law of where a debtor is “located”
- For U.S. corporate and similar registered entities, they are “located” in their state of organization, and locations of assets is irrelevant
- For most foreign entities with business in the U.S., they are deemed to be located in the District of Columbia (with exceptions)
- This makes registering financing statements and lien searching much easier
- For each entity involved, you typically only need to search and register in one jurisdiction in the U.S.

CONFLICTS OF LAWS

Other International Jurisdictions

- Some jurisdictions such as the UK have a central register, which eliminates the question of where to register (at least within the UK)

Summary

- The Canadian rules can create confusion in international transactions
- Scenario: An Ontario Corporation with only intangible assets has its chief executive office in Bermuda. Under Ontario conflicts of laws rules, this could result in looking to the laws of Bermuda to perfect security
- There are changes proposed to simplify this but they are not yet in effect

SECURITY STRUCTURE

- Most common financing structure: a corporation borrows money, and the corporation's subsidiaries (and possibly its parent) guarantee its borrowings and grant security over all of their assets to secure the guarantee
- This structure is straightforward, but can raise potential corporate law and tax issues if either the borrower itself or one or more of the guarantors are foreign (non-Canadian) entities
- Issues can also arise if the lender is a foreign lender
- **KEY IS ALWAYS TO CONSULT FOREIGN LEGAL ADVISORS (INCLUDING TAX ADVISORS) EARLY WHEN DEVISING A SECURITY STRUCTURE INVOLVING FOREIGN (NON-CANADIAN) ENTITIES**

SECURITY STRUCTURE – CORPORATE ISSUES

Financial Assistance

- Historically, many jurisdictions restricted a corporation from providing of loans, guarantees or other similar assistance to its shareholder(s) for the purposes of acquiring its own shares (or an affiliate's shares)
- These rules are often called “financial assistance” rules, and can create hurdles to leveraged buyout structures
- In Canada, these rules were historically located in corporate statutes
- These rules were largely eliminated over the last decade from the CBCA and corporate statutes in Québec, Ontario, and the western Provinces
- However, some of the Atlantic provinces (along with the territories in Canada) still maintain modest restrictions (New Brunswick, Newfoundland and PEI)
- As a result, for an acquisition financing involving any New Brunswick, Newfoundland or PEI subsidiaries, local counsel may still need to review any proposed guarantees

SECURITY STRUCTURE – CORPORATE ISSUES

- Financial Assistance restrictions do not exist in the U.S.
- However, in many other international jurisdictions, financial assistance rules continue to exist
- In the UK for instance, financial assistance restrictions still exist for public companies as follows:
 - Where a person is acquiring shares in a public company, the company or any of its subsidiaries cannot provide financial assistance for the purpose of the acquisition
 - Where a liability is incurred for a public company acquisition, the company and its subsidiaries cannot provide financial assistance to reduce that liability
- There are a number of exceptions to the UK prohibition
- A breach of the restriction could result in imprisonment or fines for the company and every officer of the company

SECURITY STRUCTURE – CORPORATE ISSUES

- In some international jurisdictions, the financial assistance rules are very strict with only limited exceptions (i.e., France)
- In other jurisdictions, the rules exist but a procedure is available (sometimes called a “whitewash procedure”) to get around the rules (i.e., Luxembourg)
 - To comply with the whitewash procedure, the board must present a report considering the proposed financial assistance and it must be published in the Luxembourg Official Gazette, etc.
- AS A PRACTICE POINT, IF A FOREIGN SUBSIDIARY IS PROPOSING TO GUARANTEE A CANADIAN PARENT’S BORROWINGS IN AN ACQUISITION FINANCING, LOCAL COUNSEL SHOULD BE CONSULTED

TAX ISSUES

- Cross-border guarantees have the potential to create tax issues in Canada and elsewhere
- Consider whether a foreign parent should guarantee a borrowing by its Canadian subsidiary or whether a Canadian subsidiary should guarantee a borrowing by its foreign parent

Canada – Tax Impact of Guarantees

- Certain tax issues to consider if a guarantee fee should be paid include:
 - Application of transfer pricing rules (imputed income/payouts)
 - Whether fee is reasonable (deductibility)
 - Withholding tax implications (deemed interest; taxable benefits)
 - Implications where guarantee is called
 - Consult a tax professional

TAX ISSUES

United States – Deemed Dividend

- A Canadian subsidiary that guarantees the borrowings of its U.S. parent can have negative tax consequences in the U.S.
- The effect of such a guarantee is that it could trigger a “deemed dividend” to the U.S. parent that is taxable, in the amount of the value of the guarantee
- This issue arises under Section 956 of the US Internal Revenue Code
- As a result of this issue, you often see foreign subsidiaries carved out from any requirement to guarantee loans to a U.S. entity, and stock pledges of foreign entities are limited as well
- THE RESULT OF THIS IS THAT LOANS TO US ENTITIES MAY NOT BE ABLE TO ACCESS CANADIAN ASSETS AS SECURITY
- However, US entities CAN guarantee loans to a Canadian Parent without any deemed dividend issue to the Canadian Parent

TAX ISSUES

Withholding Tax

- Prior to January 1, 2008, Canada imposed a 25% withholding tax on interest paid to both arm's length and non-arm's length non-residents, subject to exceptions
- Common exception was the 5/25 rule (no more than 25% of the debt could be required to be repaid within the first 5 years of its term)
- As of January 1, 2008, Canada narrowed the scope of withholding tax imposed on interest
- Today, Canada generally will impose a 25% withholding tax on interest where:
 - Interest is payable to a person with whom the payer is not dealing at arm's length with (i.e., shareholder/affiliate); or
 - The interest is "participating debt interest" (i.e., contingent on revenue or production targets, etc.)

TAX ISSUES

- Many of Canada's bilateral income tax treaties reduce the 25% domestic withholding tax rate to 10-15%
- The Canada-US treaty reduces withholding tax to 0% for those entitled to treaty benefits (including for non-arm's length loans), unless the interest is participating interest

Summary

- General rule: for an arm's length loan with no participating interest or features, there should be no Canadian withholding tax on interest
- However, for non-arm's length loans or loans that have participating interest, Canadian withholding tax may apply
- **KEY PRACTICE POINT: SEEK TAX ADVICE TO CONFIRM NO ADVERSE CONSEQUENCES AND GIVE PARTICULAR ATTENTION TO SHAREHOLDER LOANS, INTERCOMPANY LOANS AND LOANS WITH PARTICULAR INTEREST OR FEATURES**

TAX ISSUES

Thin Capitalization Rules

- The thin capitalization rules effectively limit the extent to which a foreign shareholder will finance a Canadian corporation with debt
- Where applicable, the thin capitalization rules deny interest deductions on debt that exceeds a debt to equity ratio of 1.5 to 1 (recently reduced from 2:1)
- Denied interest under the thin capitalization rules can be deemed to be a dividend (withholding tax implications)
- Generally, thin capitalization rules do not apply to arm's length debt:
 - Rules generally apply to shareholders with 25% or more of the shares of the Canadian borrower
 - Test includes any right to acquire shares (warrants, convertible debt, etc.) and shares held by non-arm's length persons
- The thin capitalization rules are complex and tax advice should be sought where non-resident shareholders are lending money to a Canadian borrower

CURRENCY EXCHANGE

- Almost all international financings involve some type of currency exchange-related issue
 - **Scenario 1:** A Canadian operating company is unable to obtain sufficient financing in Canada, and looks to other international jurisdictions (such as the U.S.) for sources of financing
 - **Scenario 2:** A foreign parent with a Canadian operating subsidiary makes the Canadian subsidiary a co-borrower under its revolving credit facility

CURRENCY EXCHANGE

International Sources of Financing

- Fortunately, with the changes to withholding tax regime in 2008, there are generally no Canadian tax impediments for foreign arm's length lenders lending into Canada
- Foreign Banks (i.e., deposit-taking institutions) are subject to the *Bank Act* (Canada) registration requirements before they can conduct banking business in Canada = more of a lender issue, and a number of foreign banks are registered
- Other non-bank entities that aren't affiliated with a foreign bank are generally less restricted under the *Bank Act*
- The result is that Canadian companies are not limited to borrowing from Canadian lenders and have a wide variety of financing sources

CURRENCY EXCHANGE

- Many Canadian corporations have historically looked to the US for funding due to greater breadth in the market, etc.
- One common source – the US high yield bond market (wide market of US investors for debt)
- Some key advantages to US high yield bond market: typically no financial maintenance covenants; looser covenants generally
- Common Scenario: Canadian corporation issues US Dollar-denominated high yield secured bonds
- With any US Dollar denominated debt owed by a Canadian company that generates income in CAD, it raises currency exchange issues
- Risk: movements in exchange rates can impact the amount of operating income required to pay the debt

CURRENCY EXCHANGE

- Currency hedges are a tool commonly used to mitigate exchange rate risk on US Dollar denominated debt owed by Canadian companies
- Currency hedges are common
- Some practical considerations when entering into a currency hedge:
 - Cost involved: will add incremental cost to any cross-border financing structure, and may eliminate any pricing advantage offered by a foreign debt provider. Can also create unexpected “unwind cost”
 - Security: most hedge providers will want to share in the security for the loan arrangement being hedged. This is not an issue if the lender making the loan also provides the hedge, but can be an issue if the lender and hedge provider are entirely different parties (intercreditor issues can be tricky)
 - Waiver rights: some hedge providers will insist on separate consent rights over amendments to the underlying loan (which can make amendments more difficult)

CURRENCY EXCHANGE

- Over the last few years, a Canadian high yield debt market has developed
- Result: ability for Canadian companies to issue CAD high yield bonds in Canada, eliminating currency exchange issues
- Market not as sophisticated or deep as in the U.S. but overall a positive development for Canadian companies

OTHER ISSUES

Accounting Standards

- Accounting standards can vary from jurisdiction to jurisdiction
 - In 2011, Canada switched to IFRS (*International Financial Reporting Standards*) for public companies and other similar institutions
 - Many other jurisdictions have also switched to IFRS
 - However, some jurisdictions (such as the U.S.) continue to use national standards, which may be different than IFRS
- Accounting standards are often present in loan agreements for purposes of financial covenants and related definitions, financial reporting requirements and other areas
- Key is to ensure correct standards are referenced and reflected